(2)

Supreme Court, U.S.
FILED
MAR 15 1995
OFFICE OF THE CLERK

No. 94-1204

In the Supreme Court of the United States

OCTOBER TERM, 1994

ALEXANDER SHOKAI, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

GILBERT S. ROTHENBERG
SARA S. HOLDERNESS
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

BEST AVAILABLE COPY

17pp

QUESTIONS PRESENTED

1. Whether the court of appeals correctly determined that *ex parte* communications between government counsel and the Tax Court did not unfairly prejudice petitioners.

2. Whether the Tax Court abused its discretion in failing to rule on the admissibility of various exhibits after it determined that they were unnecessary for resolution of the case.

3. Whether payments received by petitioner Edward Alexander were taxable at the time of receipt under the claim-of-right doctrine.

4. Whether the imposition of additions to tax for fraud under Section 6653(b) of the Internal Revenue Code violates the Due Process Clause of the Fifth Amendment or the Excessive Fines Clause of the Eighth Amendment.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	13

TABLE OF AUTHORITIES

Cases:

Barnette v. *Commissioner*, 95 T.C. 341 (1990)	13
Browning-Ferris Industries of Vermont, Inc. v. *Kelco Disposal, Inc.*, 492 U.S. 257 (1989)	12
Commissioner v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990)	6, 10, 11, 12
Guenther v. *Commissioner*, 889 F.2d 882 (9th Cir. 1989)	8
Healy v. *Commissioner*, 345 U.S. 278 (1953)	10, 11
Helvering v. *Mitchell*, 303 U.S. 391 (1938)	13
Ianniello v. *Commissioner*, 98 T.C. 165 (1992)	13
James v. *United States*, 366 U.S. 213 (1961)	12
Mullane v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950)	8
North American Oil Consolidated v. *Burnet*, 286 U.S. 417 (1932)	10, 12
Rose v. *Clark*, 478 U.S. 570 (1986)	8
United States v. *Claiborne*, 765 F.2d 784 (9th Cir. 1985), cert. denied, 475 U.S. 1120 (1986)	9
United States v. *Cronic*, 466 U.S. 648 (1984)	8
United States v. *Halper*, 490 U.S. 435 (1989)	13
United States v. *Minsky*, 963 F.2d 870 (6th Cir. 1992)	8
Ware v. *Commissioner*, 906 F.2d 62 (2d Cir. 1990)	12
Wisniewski v. *United States*, 353 U.S. 901 (1957)	8
Zobrest v. *Catalina Foothills School Dist.*, 113 S. Ct. 2462 (1993)	12

Constitution and statutes: Page

U.S. Const.:
Amend. V (Due Process Clause) 12
Amend. VIII (Excessive Fines Clause) 12, 13
Internal Revenue Code (26 U.S.C.):
§ 301(c)(1)-(3) 4
§ 316(a) 4
§ 1341 10
§ 6653(b) (1982) 12, 13
§ 6653(b)(1) (1982) 12, 13
§ 6653(b)(2) (1982) 13

In the Supreme Court of the United States

OCTOBER TERM, 1994

No. 94-1204

ALEXANDER SHOKAI, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 40-81) is reported at 34 F.3d 1480. The memorandum opinion of the Tax Court (Pet. App. 83-191) is reported at 63 T.C.M. (CCH) 1870.

JURISDICTION

The judgment of the court of appeals was entered on September 2, 1994. A petition for rehearing was denied on October 13, 1994. Pet. App. 82. The petition for a writ of certiorari was filed on January 10, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. From 1980 through 1983, petitioner Edward Alexander was the president and sole stockholder of E. Alexander Inc. (EAI), the corporate predecessor of petitioner Alexander Shokai, Inc. (ASI). EAI became the U.S. sales agent for tennis racquet strings produced by Gosen Co., Ltd., a Japanese corporation. In 1979, Gosen agreed to pay EAI a 10% commission on all sales Gosen made to EAI or to EAI's foreign customers. Gosen also agreed to make refunds to EAI if the exchange rate between yen and dollars fluctuated by a certain amount from the time Gosen billed EAI to the time EAI made payment. Gosen and Alexander further agreed orally that if the Japanese National Tax Administration (JNTA) disallowed deductions for any of the payments required by Gosen's commission and exchange rate agreements with EAI, Alexander would personally repay Gosen. Pet. App. 50-51.

Alexander instructed Gosen to deposit the commission and exchange rate payments into a personal bank account that he maintained in Japan. From 1980 through early 1984, Gosen deposited approximately $944,000 in Alexander's account. From 1980 through 1983, Alexander withdrew more than $565,000 from the account, both to pay for traveling expenses in Japan and to deposit into his personal bank accounts in the United States. None of the Gosen payments was deposited into EAI's corporate bank account or recorded on EAI's books. Pet. App. 52, 53.

Alexander described the Gosen payments to his friend Kenneth Bartelt, a retired accountant. According to Alexander, Bartelt advised him that the Gosen payments would not be taxable in the United States unless the money was returned to this country. Bartelt's son,

Edward Bartelt, prepared federal income tax returns both for EAI and for Alexander and his wife (petitioner Estelle Alexander) for each of the 1980-1983 tax years. Alexander did not inform Edward Bartelt of EAI's agreements with Gosen or of Gosen's payments, and none of the payments was reported on any of the returns filed in those years by EAI and the Alexanders. Pet. App. 52-53.

The JNTA completed an audit of Gosen in 1984. It allowed Gosen's deductions of the payments made to Alexander, but it also informed the Internal Revenue Service of the existence of the Gosen agreements, the Gosen payments, and Alexander's individual bank account in Japan. After the IRS began to investigate, Alexander consulted Edward Bartelt and other financial advisors about the Gosen transactions. They concluded that the Gosen payments had not accrued as income until the JNTA had finished its audit in 1984, because until that time Alexander had a contingent obligation to repay Gosen if the JNTA disallowed the deductions. The Gosen payments were first included on the 1984 returns filed by the Alexanders and by petitioner ASI, also wholly owned by Mr. Alexander, which succeeded to all of EAI's rights and obligations through a merger concluded in that year. Pet. App. 53-54.

In 1989, the IRS issued notices of deficiency to ASI and to each of the Alexanders. The ASI notice alleged that EAI had received approximately $944,000 in unreported income from Gosen between 1980 and 1983. The IRS also sought additions to tax based on fraud for the years 1980-1983, and based on substantial understatement of income for the years 1982-1983. The notice to Edward Alexander alleged that the Gosen payments were gross receipts of EAI that Alexander had diverted for his own use, and were therefore taxable as unreported

dividend income of about $897,000 for the years 1980-1983 and a net capital gain of about $15,000 in 1983.[1] The IRS also sought additions to tax for fraud for the years 1980-1983, and for substantial understatement of income for the years 1982-1983. The notice issued to Estelle Alexander alleged that she was liable for the same tax deficiencies as her husband and for the substantial understatement penalties for 1982-1983, but sought no penalty for fraud. Pet. App. 54-55, 115-119.

2. Petitioners filed separate petitions in the Tax Court seeking redetermination of the deficiencies and additions to tax. The court consolidated the cases for trial. Pet. App. 83 & n.1. In December, 1990, the court held a pretrial hearing on a motion by Edward Bartelt to quash a subpoena served on him by the government. *Id.* at 56-57; Pet. 12. Petitioners' counsel knew of the hearing, but was excused from attending because Bartelt's motion was the only item scheduled to be heard. Pet. App. 57.

After the court ruled on the motion to quash, government counsel submitted to the court a motion in limine, an opposition to petitioners' motion in limine, and a motion to compel production of documents, all of which were served on petitioners' counsel that same day. The court expressly reserved any ruling until petitioners' counsel could be heard. The court inquired, however, about the government's motion. In response, counsel stated the government's positions that the report of

---

[1] The notice treated the diverted funds as dividends to the extent of EAI's earnings and profits (as computed for federal income tax purposes), and as capital gains to the extent they exceeded both available earnings and profits and Alexander's adjusted basis in the corporation's stock. See generally 26 U.S.C. 301(c)(1)-(3) and 316(a).

petitioners' expert witness was hearsay and that the testimony of petitioners' accounting expert was irrelevant. The court also inquired about the status of the government's deposition of Gosen's president, to which counsel responded that he felt he was being "stonewalled" by Gosen. Finally, counsel stated that he was having serious problems reaching factual stipulations with petitioners' counsel. Pet. App. 57-59; Gov't C.A. Br. 12-13.

After trial, the Tax Court agreed with the government that the Gosen payments constituted gross receipts of EAI that had been diverted by Mr. Alexander for personal use, and that these payments should have been reported as income by EAI and by the Alexanders in the years Mr. Alexander received them. The court rejected petitioners' argument that the payments were not income in the year of receipt because of the chance that they would have to be returned if the JNTA disallowed Gosen's deductions. The court held that the payments were reportable upon receipt because Alexander received them under a "claim of right" and exercised sufficient control over their disposition. Pet. App. 139-142.

The court also found that the government had proved by clear and convincing evidence that Alexander had fraudulently under-reported his taxable income for the years 1980-1983. The court pointed to various indications of fraud, including Alexander's consistent and substantial understatements of income, his failure to keep records of the amounts earned and received from Gosen, his attempt to conceal the existence of the Gosen payments, and his inconsistent explanations of why he did not report the Gosen payments in the years he received them. Pet. App. 148-155. The court also held that Alexander's fraudulent intent could be imputed to EAI for the years 1980-1982, during which he was its sole

stockholder and dominant officer. With respect to 1983, however, the court held that the corporation was not liable for fraud or negligence because it reasonably relied on the advice of professional tax advisers in preparing its returns for that year. *Id.* at 162-168. Finally, the court sustained the additions for substantial understatement of income imposed on the Alexanders for 1982-1983 and on EAI for 1982. *Id.* at 178, 184, 188.

In a separate post-trial order the court ruled that, with exceptions not relevant here, the exhibits to which the parties had refused to stipulate were not necessary to the proper resolution of the case. The court therefore declined to rule on their admissibility. Pet. App. 195-196. The court also denied petitioners' motion for a new trial based on the allegedly improper *ex parte* communications between the court and the government's counsel at the hearing on the motion to quash. See *id.* at 56.

3. The court of appeals affirmed. Pet. App. 40-81. The court held that the court's colloquy with government counsel concerning matters not mentioned in the notice of the hearing on the motion to quash was an improper *ex parte* communication. The court concluded, however, that petitioners received notice of the motions filed at the time and an adequate opportunity to respond, and that nothing in the transcript indicated that any *ex parte* statement affected the fairness of the trial. The court therefore held that petitioners suffered no prejudice from the *ex parte* colloquy, and upheld the Tax Court's refusal to order a new trial. *Id.* at 59-60.

The court also upheld the Tax Court's application of the "claim of right" doctrine in determining that the Gosen payments were includible in income in the year of receipt. The court rejected petitioners' reliance on this Court's decision in *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), noting that the

utility company taxpayer in that case had "an absolute obligation to repay the deposits [at issue] to their customers if a request for repayment was made." Pet. App. 63-64.

The court affirmed the fraud penalties imposed against Mr. Alexander and his corporation. The court rejected petitioners' argument that Alexander reasonably relied on Kenneth Bartelt's advice that the Gosen payments were not taxable until brought into the United States and on Edward Bartelt's expertise in preparing his federal tax returns. The court noted that Alexander "failed to report the Gosen payments as income even after he had partially transferred them to accounts in the United States," and that he "failed to disclose the Gosen payments, the Gosen agreements or the oral contingent agreement" to Edward Bartelt. Pet. App. 68-69. The court also rejected petitioners' arguments that fraud could not be found where the proper treatment of the Gosen payments was unclear, that the Tax Court had applied an objective rather than a subjective standard in assessing Alexander's claimed belief that no taxes were due, and that the Tax Court had improperly disregarded evidence tending to disprove fraud. *Id.* at 65-67, 71-72.

ARGUMENT

1. Petitioners contend (Pet. 22-25) that they were entitled to a new trial because the Tax Court judge asked government counsel, at a pretrial hearing on other issues from which petitioners' counsel had requested to be excused, a series of brief questions about the government's positions on pending motions and counsel's perception of the progress of the discovery and stipulation process. The court of appeals agreed with petitioners that the judge's questions and government counsel's answers amounted to improper *ex parte* com-

munications. Pet. App. 58. Having concluded that those communications did not prejudice petitioners or affect the outcome of the trial, however, the court upheld the Tax Court's refusal to order a new trial. *Id.* at 58-60.

As the court of appeals recognized (Pet. App. 56), an *ex parte* communication, like most other procedural flaws, amounts to reversible error only if it results in some prejudice to the absent party. Petitioners cite (Pet. 22-23) criminal cases involving denial of the right to counsel, see *United States* v. *Cronic*, 466 U.S. 648 (1984), and application of the standard for finding harmless constitutional error in criminal proceedings, see *Rose* v. *Clark*, 478 U.S. 570 (1986) (reversing decision requiring per se reversal); *United States* v. *Minsky*, 963 F.2d 870 (6th Cir. 1992) (finding *ex parte* sidebar at trial not harmless). Those decisions are inapposite here.[2] The essence of procedural due process is notice and the opportunity to be heard. *E.g.*, *Mullane* v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313-314 (1950). In this case, as the court of appeals observed (Pet. App. 59-60), petitioners were served with every document filed in their absence, the trial judge explicitly stated that he would make no rulings until their counsel could be heard, and petitioners ultimately had a full opportunity to respond. After reviewing the trial transcript, the court

---

[2] Petitioners suggest (Pet. 25) that the decision below conflicts with the same court's earlier decision in *Guenther* v. *Commissioner*, 889 F.2d 882 (1989). To the contrary, the court in this case followed *Guenther* (Pet. App. 56), which held (889 F.2d at 884) that the existence of reversible error depends on whether the absent party was "unfairly prejudiced" by not being afforded "an opportunity to participate in determination of the relevant issues." In any event, any inconsistency with *Guenther* would be a matter for resolution by the court of appeals. See *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957).

was "convince[d] * * * that the *ex parte* communications did not taint the trial." *Ibid.* Under the circumstances, petitioners plainly were not entitled to a new trial.

2. Petitioners contend (Pet. 25-33) that the Tax Court abused its discretion by failing to rule on the admissibility of certain personal financial statements prepared by Edward Bartelt. Petitioners offered those statements in an attempt to show that Mr. Alexander disclosed to Bartelt the increases in his U.S. assets that resulted when he deposited portions of the Gosen payments in his U.S. bank accounts. Petitioners argue that such disclosure establishes that Alexander could not be liable for fraud because he was attempting to comply in good faith with what he conceived to be his legal responsibility (to report the Gosen payments as income if and when they were repatriated), and because the actual failure to report *any* of the payments as income was not his fault but that of Bartelt, who prepared his returns. Pet. App. 27, 30.

As the court of appeals explained (Pet. App. 68), Alexander's claim that he relied on a belief that he need only report repatriated payments is refuted by the fact that he failed to report any of the Gosen payments, including those transferred to his U.S. accounts, until 1984, after the commencement of an IRS investigation. And Alexander cannot shift the responsibility for that failure to the accountant who prepared his returns when, as the court observed (*ibid.*), the two never discussed the payments and Alexander did not disclose to the accountant the existence of either the payments themselves or the agreements under which they were made. See, *e.g.*, *United States* v. *Claiborne*, 765 F.2d 784, 798 (9th Cir. 1985), cert. denied, 475 U.S. 1120 (1986). The Tax Court carefully reviewed the evidence in this case

(see Pet. App. 146-157) and concluded (*id.* at 157) that the government had proved "by clear and convincing evidence that [Alexander] intended to evade paying taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes due." Both courts below concluded that additional evidence that Alexander had provided his accountant with financial data from which accessions to wealth could have been inferred, without discussing with him the source, nature, or proper tax treatment of those accessions, would not have changed the trial court's ultimate finding. See *id.* at 74, 195-196. That fact-bound conclusion does not warrant further review.

3. Relying on *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), petitioners argue (Pet. 33-35) that because the Gosen payments were subject to a contingent repayment obligation until the completion of the JNTA's audit of Gosen in 1984, petitioners were not required to include those payments in income until that year. The court of appeals correctly rejected that argument.

As the court of appeals held (Pet. App. 64), the Gosen payments were income when received under the claim-of-right doctrine. Amounts received under a claim of right, without restriction as to their use or disposition, are includible when received, even if they are subject to actual or potential claims challenging the taxpayer's right to retain them. *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424 (1932); see *Healy* v. *Commissioner*, 345 U.S. 278, 281-282 (1953).[3] A taxpayer

---

[3] If the taxpayer is later required to repay all or part of the money, an offsetting deduction or credit is allowed in the year of repayment. *North American Oil*, 286 U.S. at 424; see also 26 U.S.C. 1341.

holds funds under a claim of right when those funds are "received and treated by [the] taxpayer as belonging to him." *Healy*, 345 U.S. at 282. In this case, Alexander "freely withdrew money from the account [into which the Gosen payments were deposited] and treated it as his own." Pet. App. 64. The court of appeals therefore correctly held (*ibid.*) that Alexander received the payments under a claim of right, and that they were includible in income when received.

The court of appeals properly distinguished this Court's decision in *Indianapolis Power*. That case addressed the question whether utility companies that required customers to make deposits to ensure the collection of future electric bills were required to report the amounts deposited as income. The Court rejected the government's argument that the amounts received were best characterized as immediately taxable advance payments for electricity, holding instead that they were more similar to loans, and were not reportable as income until drawn down to cover a particular delinquent bill. The Court reasoned that "[t]he customer who submits a deposit to the utility, like [a] lender * * *, retains the right to insist upon repayment in cash," and "the utility therefore acquires no unfettered 'dominion' over the money at the time of receipt." 493 U.S. at 212. In this case, by contrast, the Gosen payments "bore no resemblance to loans or deposits," because "Gosen could demand repayment of [the] Gosen payments from [petitioners] *only if* the JNTA * * * disallowed the deductions." Pet. App. 64.

Petitioners focus (Pet. 33) on this Court's statement in *Indianapolis Power* that "[t]he key is whether the taxpayer has some guarantee that he will be allowed to keep the money." 493 U.S. at 210. As the court of appeals pointed out (Pet. App. 62), that statement was

made in the context of distinguishing deposits from advance payments for goods and services; it has no application in determining whether a payment for past services, which the taxpayer intends and expects to retain, is subject to such a risk of divestment that it cannot properly be viewed as current income. Under petitioners' reading, *Indianapolis Power* would effectively overrule the claim-of-right cases. Nothing in this Court's opinion suggests that result. See *Indianapolis Power*, 493 U.S. at 209 (quoting *James* v. *United States*, 366 U.S. 213, 219 (1961), and *North American Oil Consolidated* v. *Burnet*, *supra*).[4]

4. Finally, petitioners contend (Pet. 35-38) that the imposition of additions to tax for fraud under Section 6653(b) of the Internal Revenue Code violates the Due Process Clause of the Fifth Amendment and the Excessive Fines Clause of the Eighth Amendment. Petitioners did not raise those constitutional arguments before either the Tax Court or the court of appeals, and they may not properly be raised for the first time in this Court. See, *e.g.*, *Zobrest* v. *Catalina Foothills School Dist.*, 113 S. Ct. 2462, 2466 (1993); *Browning-Ferris Industries of Vermont, Inc.* v. *Kelco Disposal, Inc.*, 492 U.S. 257, 277 (1989).

In any event, petitioners' contentions are meritless. For the years in issue (1980-1983), Section 6653(b)(1) imposed an addition to tax of 50% of the entire underpayment if any part of the underpayment was due to

---

[4] Petitioners suggest (Pet. 20, 33-34) a conflict between the decision below and *Ware* v. *Commissioner*, 906 F.2d 62, 65 (2d Cir. 1990). *Ware* cited *Indianapolis Power* in holding that a partnership did not realize certain fee income for tax purposes when it was paid into escrow pending resolution of a dispute over the fee. That situation is remote from the facts of this case.

fraud, and Section 6653(b)(2) imposed an addition of 50% of the interest due on the part of any underpayment that was attributable to fraud. 26 U.S.C. 6653(b)(1) and (2) (1982). Petitioners argue that the additions in this case are excessive under the Eighth Amendment because they "bear no relationship to the harm" caused to the government (Pet. 37), and that they violate due process because "there is no mechanism for review of the amount once fraud is found" (Pet. 38). But the additions imposed by Section 6653(b) are neither arbitrary nor excessive. As this Court has recognized, the civil fraud penalty is reasonably calculated to compensate the government for the costs incurred in detecting, investigating, and prosecuting petitioners' fraud. See *Helvering* v. *Mitchell*, 303 U.S. 391, 401 (1938); see also *Ianniello* v. *Commissioner*, 98 T.C. 165, 187 (1992); *Barnette* v. *Commissioner*, 95 T.C. 341, 348 (1990); cf. *United States* v. *Halper*, 490 U.S. 435, 441-446, 449-450 (1989) (distinguishing *Mitchell*).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

GILBERT S. ROTHENBERG
SARA S. HOLDERNESS
Attorneys

MARCH 1995